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GOVERNMENTAL GAAP UPDATE SERVICE

Wolters Kluwer

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GASB-72 Was Not That Bad – Or Was It?

Summary & Highlights

Governmental Accounting Standards Board (GASB) Statement No. 72, *Fair Value Measurement and Application* has been the subject of many questions from clients so far this audit season. Many of the questions begin with "we have this investment… what level should it be at?" Some governments say something similar to "I see in [my peer government] that they are handling this investments as level 2. Do you agree that it should be level 2?" I had one chief financial officer say, "If you have questions about our investments, ask our custodial bank. I'm just the chief financial officer. I really have no idea what they do."

GASB-72 is a prime example of a *principles-based* standard, rather than a *rules-based* standard. So far this audit season, for governments with more than just investments in external investment pools managed by larger governments, understanding the standard has been a challenge. It also has proven time and again that many governments rely on a third party source without taking that healthy step backward and understanding what the provided information means.

The March 15, 2015 edition of the *Governmental GAAP Update Service* introduced readers to GASB-72. This past July 31st, the *Governmental GAAP Update Service* provided implementation ideas for the standard. This edition of the *Governmental GAAP Update Service* provides additional tips and techniques in understanding GASB-72 based on what has been experienced so far this audit season.

Analysis

Understanding the Differences in Valuation

In any situation where there are investments held, there is some form of valuation of the investments that needs to be presented in the statements of net position, the balance sheets and the notes to the basic financial statements. Depending upon the type of investment, the valuation may be at fair value, net asset value (ownership interest in a partnership, private equity, many mutual funds and others) carrying value (mortgage loans held for sale), amortized cost (positions in qualifying external investment pools or money market funds), or even by using the equity method, if applicable.

Most investments that a government may purchase will be at either fair value, net asset value or amortized cost. By focusing on the exceptions and what is allowable by state or local law, many of the exceptions to fair value, net asset value or amortized cost may not be present in most governments.

Exceptions to investments at fair value include:

- Nonparticipating interest-earning investment contracts, which should be reported at a cost-based measure in accordance with GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, paragraph 8. Unallocated insurance contracts are reported similarly, as clarified by GASB Statement No. 59, *Financial Instruments Omnibus*, paragraph 4.
- Money market investments and participating interest-earning investment contracts with one year or less to maturity should be reported at amortized cost per GASB 31, paragraph 9.
- Investments in qualified external investment pools, usually administered by statewide entities should be reported at amortized cost, if the pool qualifies in accordance with GASB Statement No. 79, *Certain External Investment Pools and Pool Participants*, paragraph 41. Otherwise, fair value.
- Synthetic Guaranteed Investment Contracts (SGICs) that are fully benefit responsive should be reported at contract value in accordance with GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, paragraph 67.
- Life insurance contracts are reported at cash surrender value.

PRACTICE POINT

Participating contracts capture market changes through the ability of the government to receive earnings through changes in fair value or sales. A nonparticipating contract cannot be negotiated or transferred. Nonparticipating contracts do not consider market rate changes. For example, many term bank deposits cannot be withdrawn without a penalty and have fixed interest rates. Therefore, they are nonparticipating. Benefit responsive contracts guarantee a contract value, even if the market value changes. Many guaranteed investment contracts (GICs) held by governments are benefit responsive.

Once the differences are understood by governments, the choices to the valuation techniques are minimized. For many governments, the investments held might be only in positions at a statewide qualified external investment pool, which are either at amortized cost or fair value.

Why the Variability in Level Reporting?

Many governments have asked this year about the levels of fair value reporting. A convenient decision would have been 'for X investment reported at fair value, the investment should be reported under level Y in the note disclosure.' Many governments have reviewed peer government financial statements, found a similar investment in the government's fair value disclosure and recorded their own investments at a similar value.

Using another government's reporting of investments at fair value to be guidance for the reporting government's disclosure may not always result in proper reporting in accordance with GASB-72. In representation letters signed by management near the end of an audit, management is ultimately responsible for fair values of investments, even if they use a third-party service for information. Therefore, a management process must be in place to develop the valuation information or review and accept the third-party pricing service.

GASB-72 also allows aggregation of information for measurement, recognition or disclosure. This aggregation is known as the *unit of account*. The level of an asset or liability is aggregated or disaggregated in the disclosure will vary from government to government based on an individual government's investment goals and operations. Therefore, the inputs used and the unit of account will derive different levels for different governments for seemingly similar investments.

PRACTICE POINT

A common problem in the unit of account is with blended component unit reporting at a primary government. Component units may report different levels for fair values than a primary government, resulting in similar investments reported in multiple levels in the primary government's disclosure. The chief accounting officer of a primary government should try to normalize the reporting between blended component units and the primary government using the same practices and procedures. But this may not be possible in all circumstances.

Governments also need to be reminded of the levels of inputs to valuation techniques used to measure fair value. Level 1 inputs are unadjusted quoted prices in active markets for *identical* assets or liabilities. Level 2 inputs are other than quoted prices that are still observable either directly or indirectly. Level 2 reporting so far this year has primarily been the result of analysis of yield curves. Level 3 inputs are unobservable and are derived from management's assumptions.

In general, management should be able to easily prepare Level 1 input information or review information from a third-party pricing service. For example, General Electric stock trades daily, with values posted on multiple pricing services. Management should be cautious though if there is a spread between 'bid' and 'ask' pricing. A common practice is to pick a middle value.

Even bonds and similar debt issuances may result in management's conclusion that they are Level 1. Many pricing services show trading activity in bonds and similar on a daily basis. For example, a client asked if a particular municipal bond investment should be Level 1 or Level 2 or net asset value. Of course I responded that it was ultimately management's decision, but the particular bond pricing was found easily on a Bloomberg report as of the government's fiscal year end. Similar pricing was found on two different reputable reporting services for the same bond with the same maturity. Management could make a case that the particular bond was a Level 1. Therefore, there could be variability in reporting from government to government.

Management Uses a Third-Party to Price Investments

Some governments use a third-party pricing service to determine the value of investments. This provides some comfort in reporting, but may result in audit issues for the government. Again, management is ultimately responsible for the values of investments reported. In some cases this year, auditors have found variability in Level reporting even within the same pricing service. In other cases, no Levels were reported and additional evidence was needed to determine a value. Auditors should also not use the same pricing service as management to provide relevant and reliable audit evidence for fair value measurement.

The AICPA *Audit and Accounting Guide – State and Local Governments*, paragraph 5.75 details some relevant matters when management uses a third-party pricing source for valuation information. Consideration should be given to the type of services provided by the pricing source. For example, some services provide more information about how the values were derived, while others provide limited or no information about the inputs and assumptions. The nature of inputs used and the complexity of the valuation technique is also important to both management and auditors. As discussed above, a publicly traded security is relatively easy to corroborate and more reliable to that of a mortgage-backed security for example. The reputation of the third-party pricing source is important. Many third-party pricing sources are well-known and experienced, while others may be not. If a source is new to pricing, more skepticism may be needed to determine whether the values presented are fairly stated. One of the more difficult concerns is the objectivity of the pricing source. Ultimately, the pricing source has a contractual relationship with management and may be incentivized and provide less reliable information. For example, a large custodial bank settled earlier this year with the United States Department of Justice for $382 million as a result of fraudulent foreign currency exchange practices. Finally, management should exercise controls over the use of third-party pricing sources, assessing their reliability of information. This may include an independent review and approval of the information and a determination of the completeness, relevance and accuracy of pricing and price-related data. Some pricing services do present a *Service Organization Controls* report, which may provide some level of assurance, but not ultimate assurance due to the nature, timing and extent of the report.

A good control for management may involve obtaining information from multiple pricing sources. If there is some variability in the pricing and information, the wider the disparity for the same investment, the more uncertainty. However, obtaining multiple pricing may not always work for Level 2 and Level 3 investments, as multiple services may be using the same underlying information to derive the valuations.

Conclusion

For many governments with simple investments (or no investments at all,) GASB-72 may be much ado about nothing. Their investments may be restricted by law or regulation to a statewide administered external investment pool, which would be reported at either fair value or amortized cost in accordance with GASB-79. Other governments such as defined benefit plans and endowments have had a much more difficult implementation of GASB-72 due to the nature of their operations.

Furthermore, investment levels *may not be the same from year to year.* Different investments may be held from period to period and management may change the focus of its investments due to changing market conditions. Therefore, management should institute a process to determine the valuations with each reporting period and if a third-party pricing service is used, include an air of skepticism on the valuations to independently confirm whether or not the values are fairly stated.

About the Author

Eric S. Berman, MSA, CPA, CGMA, has over 26 years of governmental accounting and auditing experience and is a partner with Eide Bailly LLP. Previous to Eide Bailly LLP, he was a quality control principal with a public accounting firm in California. His public sector experience includes being a Deputy Comptroller for the Commonwealth of Massachusetts from 1999 to 2010, and the Chief Financial Officer of the Massachusetts Water Pollution Abatement Trust from 1994 to 1999. Eric is a licensed CPA in Massachusetts. He obtained an M.S. in Accountancy from Bentley University. Eric recently represented the Association of Government Accountants (AGA) as the Vice Chairman of the Government Accounting Standards Advisory Council to GASB. He was the previous chair of the Financial Management Standards Board and is the Chairman of the AGA's Audit Committee. Eric is the president of the AGA's Boston Chapter. He also is a previous chair of the American Institute of Certified Public Accountants (AICPA) Governmental Performance and Accountability Committee and is a former member of the AICPA's State and Local Government Expert Panel. He was recently named to the GASB's Financial Reporting Model task force. Eric is frequently called upon to consult and train state and local governments throughout the country on governmental accounting and auditing.

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Sizing Up Georgia's Budget Before Legislators Get Back to Work

All in all, the state is on very solid footing from a fiscal perspective going into the 2017 legislative session. Let's take a quick look.

First, will the state make budget in 2017? The Great Recession has taught me to be cautious, but barring a major disruption, there is no reason to think that fiscal year (FY) 2017 won't go smoothly. The FY 2017 general budget was based on $22.5 billion in state general fund tax and fee revenues. Originally, FY 2017 was based on a projection of 3.8 percent growth over the FY 2016 amended budget estimate. Happily, FY 2016 revenues ended around 2.5 percent above the final estimate for that year, leaving a $538 million surplus. FY 2016 overall growth was around 4.7 percent after deducting new revenues from HB170, the transportation bill. This means that FY 2017 only requires around 1.28 percent growth in tax and fee revenues to make budget.

October revenues (as tracked by the state Department of Revenue) were at 4.8 percent growth year-to-date, with income taxes coming in at 3 percent year to date and sales taxes tracking at 4 percent. Odds are the state would easily make the current estimate. Based on prior year decisions, I expect the governor to only make a small adjustment upward in the FY 2017 estimate to cover a few modest increases. Items likely on the agenda include the need to cover Medicaid growth of $115 million and around $135 million in K-12 growth.

What will happen in FY 2018? These days everyone is asking about the impact of Donald Trump's election on the economy and thus the budget. Unfortunately, I have not the foggiest idea and nor does anyone else. The basic conventional wisdom from macroeconomists is pretty straightforward: If we have a trade war with other countries, the economy and state revenues will suffer. If the president and new Congress pass stimulus legislation, the economy and state revenues should do well at least in the short term. But, who knows. Macroeconomic forecasting is difficult even in the most certain of times, and the president-elect has proposed a number of major policy changes from health care reform to tax policies changes, all of which could have varied impacts on the economy.

Another consideration is that the National Association of State Budget Officers is reporting that 24 states are projecting that FY 2017 revenues will come in below estimates, and 25 states ended FY 2016 below their original estimates. Some of these are natural resource dependent states that are hurt by low oil and gas prices, but a number of others are income and sales tax dependent states like Georgia that are simply seeing a softening in growth across both of these tax streams. That being said, there is no evidence to date that this is affecting Georgia.

Assuming economic growth continues along the same trajectory as the previous few years, we can estimate revenues will grow in the 4-5 percent range. The governor and Office of Planning and Budget have been clipping a percentage point off of the forecast to be prudent and to rebuild the reserves, so conservatively, I would guess the governor will propose revenue growth of around 4 percent, or around $900 million.

As with previous years, almost all of this is going to be needed to fund basic growth:

- $217 million increase in pension contribution requirements
- $216 million for education growth, and $166 million to finally close the gap in austerity funding
- $121 million for Medicaid growth

- $82 million for Board of Regents growth (not including retirement contributions)
- $54 million for growth at the Department of Behavioral Health
- $53 million for governor's proposed 20 percent pay raise for law enforcement

These priorities alone total up to about $900 million. Other items that could be on the table are a pay raise — 1 percent statewide would cost around $125 million, and last year, reform of the education funding formulas was priced at about $241 million. Medicaid expansion, which was previously discussed, is pretty obviously off the table. The state legislature will also need to tackle reauthorization of the Medicaid provider fee.

More generally, the state goes into FY 2018 on a solid financial footing. As has been widely reported, the state expects to have around $2 billion in its revenue shortfall reserve going into FY 2018. The state's general obligation debt burden appears to be around 6 percent of prior year treasury receipts. The constitutional limit is 10 percent, though the state tries to keep debt below 7 percent of prior year revenues.

The state is making its full actuarially determined contribution to all major pension plans, and it has made some significant strides to start funding its other post-employment benefits (OPEB), largely retiree health care obligations, for state employees. The OPEB liability for teachers remains a concern, with the state owing $873 million annually in required contributions and falling short by $465 million. The Board of Regents also faces a $184 million shortfall in its annual required contribution for OPEB. But unlike most other states, at least Georgia is taking some positive action to start addressing these issues. Many other states are simply letting this liability accumulate.

In sum, the state is not generating enough money to take on any big, new spending initiatives, but by and large, has its fiscal house in order. The last major challenge for the state from a fiscal policy perspective is tackling OPEB, and the state has taken some steps in this direction.

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Georgia Fiscal Management Council

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FMC Spotlight

Monthly Meeting

We would like to extend a special thank you to the following Speakers that presented various topics to the Council during the last quarter:

October

GFMC Conference

November

House Budget and Research Office presentation by Martha Wigton and Christine Murdock

December

No formal meeting held